NACDS NATIONAL ASSOCIATION OF CHAIN DRUG STORES

July 27, 2004

Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Submitted via e-mail
regs.comments@federalreserve.gov

Re: Response to Notice of Study and Request for Information
Disclosure of Debit Card Fees
Docket Number OP-1196

Dear Ms. Johnson:

The members of the National Association of Chain Drug Stores ("NACDS") appreciate the opportunity to provide comments on the May 18, 2004 Notice of Study and Request for Information related to the disclosure of fees charged by banks for the acceptance of debit cards. The acceptance and increasing costs of debit cards are important issues for the members of the NACDS. NACDS members work diligently to reduce and control costs in order to provide efficient high-quality services to consumers. The recent dramatic increases in debit card fees raise serious concerns for NACDS and its members. Although the disclosure of banking fees is often important for consumers, we believe that the obligation of disclosure appropriately should fall on card-issuing banks and that those banks should improve their disclosures. Proposals that would place the burden of disclosure on retailers at the point of sale are misguided and will not assist consumers.

NACDS members are more than 200 chain pharmacy companies, as well as over 1,000 suppliers of products and services to the chain drug industry. NACDS members operate more than 32,000 community pharmacies, employ more than 110,000 pharmacists, fill more than 2.1 billion prescriptions yearly, and have annual sales of more than $500 billion. For more information about NACDS, visit www.nacds.org.

NACDS applauds efforts by the Federal Reserve to analyze the costs and competitive effects of debit card acceptance fees. There are primarily two types of fees for debit cards: (1) an interchange fee that the merchant pays the bank for acceptance of the transaction; and (2) a consumer surcharge assessed by the card-issuing bank to the consumer, typically for PIN debit transactions. In many respects, competition in the debit card payment system appears to be broken. In the past 12 months alone there have been 11 increases in interchange fees, and for many networks fees have increased over 200% in the last three years. The dramatic increase of these interchange fees is remarkable

413 North Lee Street
P.O. Box 1417-D49
Alexandria, Virginia
22313-1480

(703) 549-3001
Fax (703) 836-4869
www.nacds.org

because there have been no significant increases in the cost of accepting debit cards. The fact that fees have increased while the costs have decreased strongly suggests that the competitive system is not working.

At the same time, consumer surcharges for the acceptance of PIN debit cards have begun to be imposed and have increased significantly. Consumer fees for these transactions are quite puzzling. Unlike other surcharges imposed by financial institutions, these fees do not appear to be intended to recover any additional costs borne by financial institutions. Rather, they seem to be imposed to drive consumers to more costly, less secure modes of conducting electronic financial transactions.

Part of the problem is that financial institutions receive a higher interchange fee for the acceptance of signature-based debit cards than for PIN-based debit cards. Signature-based debit cards are a less attractive payment method in a number of respects. Signature-based cards are more expensive and have a higher rate of fraud, and typically involve slower, less efficient transactions. Yet financial institutions tend to favor signature-based cards because they receive a higher interchange fee from merchants. This creates the perverse incentive for financial institutions which surcharge cardholders additional fees to steer them to use more expensive signature debit cards.

Further disclosure of fees might address the symptoms, but not the cause of the problem. It is the interchange fee system which creates the perverse incentives to charge more for the more efficient, less costly payment method. NACDS respectfully suggests that the Federal Reserve Board should carefully consider the impact of the current interchange fees on the efficiencies and costs of payment systems.

Although requiring disclosure of fees can often improve the competitiveness of a system by alerting consumers about the real costs of a product, in this case the current and proposed disclosure rules fail to serve that purpose. Under the current disclosure rules, consumers are confused as to the source of the surcharge. Typically in the consumer's statement the banks identify the merchant at which the transaction occurs, giving the consumer the impression that it is the merchant, not the bank, that is assessing the surcharge. Moreover, financial institutions fail to clearly indicate to consumers on a regular basis their policy for assessing surcharges for online debit transactions. It is our experience, based on our members' regular contacts with customers, that the practice of disclosing the fee amount adjacent to the name of the drug store on the customer's bank statement creates the false impression that it is the drug store imposing the debit card fee. Banks need to clearly state that the bank imposes the fee, not the merchant.

The approach proposed in the Federal Reserve Board's comments would fail to improve the system of disclosure. Under the proposal, merchants would be obligated to disclose the amount of the surcharge at the point of sale. It is highly unlikely that consumers would recognize that the surcharge was being imposed by the financial institution and again would be confused that the merchant was imposing the fee.

Moreover, this proposal presents substantial technical and administrative problems for merchants. Merchants will not readily know the amount of the surcharge being imposed and thus an additional message would have to be sent between the merchant and the financial institution to determine the amount of the surcharge. This would create significant, additional costs to merchants in terms of telecommunications equipment, longer waiting times and retraining of personnel.

NACDS believes that it is inconsistent with sound regulatory policy to require retailers to bear the cost of disclosing fees that are imposed by financial institutions. Imposing this obligation on retailers will not address the current problems with additional surcharges imposed by financial institutions for the use of PIN debit cards. The current system, in which financial institutions attempt to drive consumers to a form of payment which imposes greater costs on retailers and is less secure, makes no sense.

The ultimate problem with the debit card payment system is the use of interchange fees. It is not surprising that regulators in many other countries, including Australia, Israel, the U.K. and the European Union, have begun to regulate interchange fees. Retailers are prohibited by card associations' rules from directing consumers to more efficient, less costly methods of payment. Higher interchange fees become costs of doing business and are passed onto all consumers regardless of whether they use cash, credit, checks or debit. The current practice by financial institutions of imposing surcharges on debit cards provides incentives drives consumers to more expensive and less efficient methods of payment and is not in the interest of consumers or retailers.

Thank you for the opportunity to present our views on this important aspect of our business.

Sincerely,

NATIONAL ASSOCIATION OF CHAIN DRUG STORES

Donald Bell, General Counsel